2011 COMPETITIVE BID HEARING

Findings and Recommended Rental Rates for Agricultural and Grazing Lease Nos.

1004, 1272, and 10471

A report to the State Board of Land Commissioners by

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On March 22, 2011 the Department held Competitive Bid Hearings for State of Montana Agricultural and Grazing Leases Nos. 1004, 1272, and 10471, which are being renewed in 2011. These new ten-year leases will expire on February 28, 2021. If a Lessee wishes to renew the lease for another term he must submit an application. If other persons inquire about the availability of a lease, their names and addresses are noted in the file and they are sent applications and bid forms at the time of lease renewal.

The statutory absolute preference right within Section 77-6-205(2), MCA, to renew a State agricultural and grazing lease was declared unconstitutional by Judge Jeffrey Sherlock in Broadbent v. State of Montana, et al., First Mont. Judic. Distr. Ct., Cause No. BDV-2003-361, because it impermissibly interfered with the constitutional power of the Land Board, under Art. X, Section 4 of the Montana Constitution, to choose its lessees. The Land Board, in response to Judge Sherlock's ruling, amended ARM 36.25.117 to exercise its constitutional prerogative to grant a qualified preference right to incumbent lessees in good standing. Through this rule, the Land Board has expressed its qualified preference to issue renewals of agricultural and grazing leases to the incumbent lessee provided that they have not committed illegal subleasing and do not have a history of lease violations. However, in all instances, the Board has reserved the right to choose the best-qualified lessee.

As part of its constitutional power, the Land Board may also determine the rate at which such leases will be issued. The Land Board has recognized that full market value encompasses the concept of sustained yield. Section 77-6-101 MCA. In Jerke v. State Dept. of Lands, 182 Mont. 294, at 296-297, 597 P.2d 49 at 50-51 (1979), the Montana Supreme Court held that a Grazing District which was not a lessee of a state grazing lease could not exercise a preference right. The Court described the rationale of the preference right to meet a high bid as follows:

> Sustained yield is the policy which favors the long term productivity of the land over the short term return of income. State ex rel. Thompson v. Babcock, supra. The preference right seeks to further this policy by inducing the State's lessees to follow good agricultural practices and make improvements on the land. This is accomplished by guaranteeing that the lessees will not lose the benefits of their endeavors by being outbid when their leases terminate. They are preferred and may renew their leases by meeting the highest bid submitted.

Id.

Exercised in such a manner, such a preference is in the best financial interests of the school trust beneficiaries. All other things being equal, the Land Board has recognized that stability of land tenure encourages existing lessees to make greater improvements in the land, knowing that they will likely be able to utilize these improvements in the future, and that stability of tenure allows lessees to operate more efficiently. The duty to maximize revenue return to the trust estate from the trust properties is always subject to the duty to preserve the financial productivity of the trust lands. Oklahoma Education Association v. Nigh, 642 P.2d 230 at 238 (1982)

No Applicant for a grazing lease can compel the State Board of Land Commissioners to grant it an interest in state trust lands, especially where the concept of sustained yield is ignored. See, Skillman v. Department of State Lands, 188 Mont. 383, 613 P.2d 1389 (1980); Gibson v. Stewart, 50 Mont. 404, 147 P. 276 (1915)(Whether a tract of state land shall be leased is a question addressed to the sole discretion of the Land Board.); §77-6-206, MCA ([T]he board may withdraw any agricultural or grazing land from further leasing for such period as the board determines to be in the best interest of the state".)

Under ARM 36.25.117, if the Lessee exercises the qualified preference right but believes that the bid amount is excessive, he or she may request a hearing. The purpose of the hearing is twofold: 1) to determine the best-qualified Lessee for the upcoming lease term; and 2) to ascertain the appropriate rental rate for that term. Specifically, the Director inquires whether the high bid amount represents the fair market value of the lease and whether the rental rate is truly in the best interests of the trust. In determining whether the "high bid" rental rate is in the best interests of the beneficiaries of the trust, the Land Board must utilize the criteria set out in §77-6-205(2), MCA, and in Thompson v. Babcock, 147 Mont. 46, 409 P.2d 808 (1966). Under these criteria, the Montana Supreme Court has held that the "high bid" may be rejected where it is either "...above community standards for a lease of such land, would cause damage to the tract, or impair its long-term productivity".

The Montana Supreme Court has recognized that an excessive rental rate, at some point, economically compels a Lessee to graze all the available forage on a grazing lease or reduce costly fertilizer, herbicide, and summer fallow treatments on agricultural leases. When state lands are over-grazed or farmed with minimal input costs, they produce more noxious weeds, less forage or crops, and less future income for the beneficiaries of the various trust lands. In extreme cases, the productivity of the land may be permanently damaged. It is in the best interests of the State to set a rental rate which balances the competing factors. In this "balancing act", the Land Board is attempting to maximize long-term income by allowing the Lessee a sufficient monetary incentive to exercise wise range management and agricultural practices. If the rate is too low, the State will not receive full market value for its lands. If the rate is too high, the Lessee will be induced to over-graze the tract, or reduce inputs such as herbicides, and long-term trust income will inevitably suffer.

In the competitive bid hearing process, the Director is recommending the rental rate for the next term of the grazing or agricultural lease. The economic viability of these leases fluctuates according to prevailing weather conditions and commodity prices; both of which can vary wildly. Despite these fluctuations, the grazing rental charged by the Board must be paid by the Lessee whether or not any forage upon the lease is utilized. By contrast, private lessors generally do not collect rentals when they no longer have forage available for lease. Consequently, setting an appropriate rental rate, so as to sustain the long-term viability of "school trust" leases and maximize long-term income, is simply not as easy as accepting the highest bid. If it were, there would be no need for a hearing on the subject.

The best lessee is chosen according to nine criteria set out within ARM 36.25.117:

1) an intended grazing or cropland management plan for the new term of the lease;
2) experience associated with the classified use of the land;
3) other non-state lands that are fenced and managed in common with the state land;
4) intended grazing or cropland improvements that will benefit the health and productivity of the state lands;
5) a weed management plan;
6) management goals and objectives and monitoring procedures to determine if they are being met;
7) the method or route used to access the state land;
8) any other information the director deems necessary in order to provide a recommendation to the board; and,
9) the incorporation of all or part of this information as terms and conditions in the new lease agreement.

The current policy of the Board authorizes the Director of the Department to hold the competitive bid hearings; hear the evidence; and make recommendations to the board. Since the rental rates must be based upon the evidence presented at the hearing, the Board members must avoid consideration of information outside the hearing record.

This year the Director granted one request for hearing on three leases. The hearing was conducted on March 22, 2011 at the offices of the Department in Helena, Montana via a video link to the Department's offices in Glasgow, Montana. The hearing was electronically recorded and all witnesses testified under oath. However, the hearings were conducted in an informal manner. Present at the hearings were: Director Mary Sexton; Trust Lands Management Division Administrator Tom Schultz; Agriculture and Grazing Management Bureau Chief Kevin Chappell; Trust Lands Attorney Tommy Butler; Glasgow Unit Manager Hoyt Richards; Land Use Specialist Randy Dirkson; the Lessee, Matt Miller and Lynn Miller; and the High Bidder, Jason Sauer.

In preparation for this hearing, both the Lessee and the High Bidder were notified of the time and place of the hearing and given copies of ARM 36.25.117. When appropriate to the hearing, the Commissioner accepted in the evidentiary record, the following evidence:

1. The Department's County Competitive Agricultural Lease Bid Summary for Valley County for 2010.

2. The Montana Agricultural Statistics Service Report of Agricultural Cash Rent Survey for private leases in Valley County, Montana reporting an average rate of $20.50/acre.

The testimony and evidence considered during the hearing; a summary of the hearing; and the findings and conclusions recommended are set out as follows:

2011 COMPETITIVE BID HEARINGS

Hearing Time: Tuesday, March 22, 2011 @ 9:00 a.m.

Lease No.: 1004 County: Valley
Lessee: Miller Brothers Land Company Inc.

Lease No.: 1272 County: Valley
Lessee: Matthew Miller

Lease No.: 10471 County: Valley
Lessee: Miller Brothers Land Company Inc.

Tracts:
T31N R40E S31: Lots 6 & 7, NE¼, N½SE¼ - 319.64 Ac. - Common School Grant
T31N R40E S32: Lots 1-4, N½S½, W½NW¼ - 398.87 Ac. - Common School Grant
T29N R39E S36: NW¼, N½SW¼, SE¼SW¼ - 280 Ac. - Common School Grant

Grazing Acres: 93.25 AUM Rating: 25 Ag (Crop) Acres: 878.3

High Bidder: Jason Sauer
High Bid: The greater of 41% crop share or $31.00 per acre
Other Bids: None

Previous Rental:
L# 1004 – Minimum
L# 1272 – Minimum
L# 10471 – The greater of 47% crop share or $27.00 per acre

<u>Prevalent Community Rental Information:</u>
State Land County Grazing Bid Average: $14.72 per AUM
State Land County Cropland Bid Average: 36.76% or $31.00 per acre
USDA NASS Valley County 2010 Cash Rent Survey Information: $20.50/Acre

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Findings: The Lessee, Matthew Miller (on his own behalf and as President of Miller Brothers Land Co., Inc.), Lynn Miller, and the High Bidder, Jason Sauer, appeared and testified. Mr. Miller previously submitted written materials which discussed the profitability of these three agricultural leases given various levels of rental rates and productivity. He stated that all three leases have been managed by him under a wheat/chemical fallow rotation to conserve moisture.

He testified that Leases Nos. 1272 and 1004 experience lower precipitation and greater prevalence of rocks than Lease No. 10471. Due to less precipitation on Leases 1272 and 1004, he believed that those two leases could not be profitably farmed utilizing a wheat/lentils rotation. Mr. Miller cited that he and his family have several decades of experience farming these leases and the lands surrounding them, and that Miller Brothers knew the characteristics of the local soils and their productive capability. He stated that Miller Brothers had direct access to all the leases, since they held private lands directly adjacent to these State leases and that these State leases were directly accessible by public roads.

Mr. Miller believed in the importance of applying fertilizer with micro-nutrients like potassium and phosphorous to these lands to maintain their productivity. Mr. Miller has diligently endeavored to control noxious weeds by spraying herbicide. He has found that applying herbicide during the early Fall is an effective method to control perennial weeds, since the herbicide is carried down into the weed’s roots. Typically, Mr. Miller conducts his monitoring of the crop when making a pass through the field with machinery. Mr. Miller stated that he has a proven history of production upon these lands, and that he has a good relationship with the DNRC Glasgow unit office.

Mr. Miller stated that the conditional preference right to meet the high bid is a valuable right, because it allows some stability of land tenure and encourages a lessee to make improvements to the land. Mr. Miller contended that $20.50/acre cash rental was a viable rental rate. Mr. Miller doubted that the $31.00/acre high bid represented a viable rental rate, because he questioned whether wheat prices would remain at elevated levels for the next ten years, and whether future input costs would moderate. Mr. Miller stated that although these leases receive some degree of recreational use, it does not appreciably interfere with the farming of these lands.

Mr. Sauer stated that he knew of a nearby tract of 7,200 acres in Valley County which had recently been rented at the rate of $30.00/acre. He stated that farmers can partially address uncertainty in future prices by contracting for future crops at guaranteed prices for up to two years in the future. If he was awarded these leases, Mr. Sauer contemplated utilizing a continuous cropping method, rotating between the production of wheat, lentils, and peas. Due to the nitrogen-fixing properties of legumes, crop rotations with legumes can increase both the productivity of the soil and grain yields, while reducing fertilizer costs. Such rotations can also appreciably reduce insect and disease problems. However, crop rotations require additional planning and management skills, and such rotations increase the complexity of farming.

Mr. Sauer expected that wheat prices may vary in the future, but he testified that the lowest cash leases that he has currently seen in the area were $25/acre, and that with inflation, he expected those rental rates to increase. Mr. Sauer also observed that Miller Brothers had successfully farmed Lease No. 10471 with a 47% crop share rental and a $27.00/acre minimum cash guarantee for the past ten years. A review of the lease file, shows that in the past eight years, the cumulative amount of rental paid to the Department upon Lease No. 10471 has been $67,401.00. The lease comprises 265.7 agricultural acres. Given those payments over that 8-year period of time, the average return per acre to the trust on Lease No. 10471 has been $31.70/acre ($67,401 divided by 265.7 acres divided by 8 years = $31.70). Despite the level of those rental payments, the Lessee has done an excellent job of keeping this tract productive and weed-free, with no soil erosion.

Although there are slight variations in soil qualities among these three leases, the Director finds that they can be highly productive given proper management. Matthew Miller and Miller Brothers have exercised great care in their farming of these lands and produced good quality crops on all these leases while keeping them free from weeds and erosion. Mr. Sauer made a compelling case why these lands could be successfully farmed at the rate of $31.00/acre, and why that rental rate currently represents the prevailing community standard. That rental rate is corroborated by the Department's Valley County State land competitive bid average of a 36.76% crop share with a $31.00/acre minimum cash guarantee.

Nonetheless, the Director recognizes that Mr. Miller and Miller Brothers gave a more comprehensive presentation on the nine management elements upon which to choose the new lessee. Based upon that presentation at the hearing, along with the proven record of past farming practices by Mr. Miller and Miller Brothers, the Director concludes, pursuant to ARM 36.25.117, that Mr. Miller and Miller Brothers would be the best lessees for the upcoming term of these leases.

Recommendation: The Director recommends that Leases Nos. 1004 and 10471 be re-issued to Miller Brothers Land Company, Inc., and Lease No. 1272 be re-issued to Matthew Miller at the Valley County state land competitive bid average of a 36.76% crop share with a $31.00/acre minimum cash guarantee.